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OBSERVATIONS ON TAX POLICY
AND AGRICULTURE *

by
Dr. Mark A. Edelman **
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ABSTRACT: A short clarification of the current problems facing agriculture and tax policy options available.

* Testimony to the United States Congress, Joint Economic Committee Hearings On Tax Policy and Agriculture, Senator James Abdnor, Chairman Brookings, South Dakota, February 13, 1985

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OBSERVATIONS ON TAX POLICY
AND AGRICULTURE

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Mr. Chairman, it is my privilege to address your distinguished committee on the profound challenges that are facing agriculture and possible impacts of some of the tax policy proposals. First, let me reiterate that my assumed role as an educator is to assist in clarifying the problems, outlining alternatives, and discussing the probable consequences of policy options, so that citizens and their leaders have a broader appreciation of the facts for public decision-making.

Having said that, let me focus my remaining remarks into two areas: (1) the nature of the agricultural problems as they relate to tax policy and the present financial stress, and (2) the tax policy options available to government in the present situation.

Short-Run Versus Long-Term

Very simply the short-run problem as perceived by many farmers is: "How do you stay in business another year?" The long-term problem as viewed by others is: "What should be the structure of agriculture and who should own the land?" Let's look at each in turn.

First there is no question that the rules of the economy have changed from the buy now-pay later inflationary 1970s

to the pay-as-you-go 1980s with interest rates above the inflation rate. Second, the more than 40% rise in the exchange value of the dollar since 1980, has reduced our export potential and stimulated imports. As long as we are committed to fighting inflation, we are likely to see a much higher value of the dollar than was true for the 1970s.

As a result, agricultural producers cannot survive during the 1980s with debt levels that many incurred during the 1970s. While 70 to 80% debt was the debt lid of the 1970s, 50 to 60% debt may become the debt lid of the 1980s. A recent FARM JOURNAL survey showed that 1/3 of our nation's agricultural producers have debt-to-asset ratios over 40%.

With current levels for interest rates and grain prices, it is common to find producers with an adequate return before debt service and negative return after debt service. For the 1/3 of the nation's farmers that hold 2/3 of the farm debt, the short-term problem is to reduce their debt level in order to shift the return on debt over to the operator's earned net worth.

However, in spite of all management attempts to survive, in all likelihood, we will see a dramatic increase in agricultural land transfers through voluntary, involuntary, and foreclosure sales. The normal annual rate of land transfer during the 1970s was about 3 to 4% of the land base. The supply of land available for sale during the next 3 to 5 years might be more than double previous rates in some states. Colleagues in the neighboring state of Iowa are talking even higher rates for their state. As a result,

land values are likely to remain soft and a short-run policy problem has developed: "How much agricultural land should be available for sale at any one time and who should be allowed to purchase it?"

One concern that has philosophical roots in agricultural fundamentalism is the belief that land ought to be owned by those who till the soil. On the other hand, the contemporary view of market oriented philosophy is to sell land to the highest bidder, regardless of buyer occupation or residence.

Who will buy the land in 1985 and 1986? Low-debt farmers with cash are interested in buying land for future expansion as cheaply as possible. Bargain land and machinery prices may give rise to a new generation of entrants into agricultural production. Many successful farmers of the 1960s and 1970s were those who bought cheap land at the end of the Great Depression. In addition, a growing number of agricultural lenders and private investment firms are entertaining discussions on how to package agricultural land for national investment markets and nonfarm investors.

Should agricultural lenders who acquire land through foreclosure immediately sell that land to other farm and/or nonfarm investors or should they be given incentives to hold land off the market and lease it to farmers until the land market stabilizes? Should government allow a rapid decline in land prices to continue or should it step in and acquire foreclosed land to absorb part of the lender's asset loss and lease it back to foreclosed farmers with an option to buy?

In addition, one farm management option that has been considered by some high-debt producers is to lower their farm's debt service by taking on new partners with equity capital. Conceptually, this can be done through general partnerships, limited partnerships, and family corporations, as well as other nonfarm investor partnerships, corporations, or private sale-lease-back options. Under some circumstances, it must be said that this option can assist some producers in surviving their current farm finance situation.

These trends imply that changes in tax policy that would limit nonfarm investment would also tend to reduce the capital available for investment in high debt farms prior to foreclosure and for purchases in the land market. As a result, land values would tend to decline even more sharply in regions where significant nonfarm investment opportunities might otherwise exist.

In contrast, there are those who believe that our national tax policies give tax preferences to nonfarm investors and that our policies should foster moderate size, pastoral family farm ownership. Specifically, graduated tax rates coupled with investment credit, accelerated depreciation, and capital gains provisions give larger deductions to high tax-bracket nonfarm investors than to lower-bracket agricultural producers.

Senator, your research highlights the results of the current tax policy on the structure of agriculture. For example, fed cattle numbers have been on the rise in

the feedlots of the Southern Plains. A significant number of these fed cattle are in custom feeding operations that cater to tax shelter investments. However, fed cattle numbers in the Upper Plains have been declining. Most of the cattle in this region are fed in moderate size owner-operated feedlots on diversified farms. While it is difficult to separate out the impacts due to regional resources available, economic efficiency, and regional demand differences, tax policy has been a factor in this operating environment.

Many in my profession attempt to debate whether tax policy is neutral or not. My point is that people usually define neutral as their present tax bill minus 10%. There never will be a "fair and equitable" tax system that is acceptable to everyone. Therefore the question is: What type of agriculture do we want and what tax rules would pass Congress and still head us in that direction?

Do we want dispersed land ownership among farm and nonfarm people? Should land be owned by those who farm it? Is it alright to have the land held by a few people or corporations? Does land ownership constitute control? Does the current financial stress in agriculture take precedence over our long-term land ownership objectives?

Agriculture And Tax Policy Options

Option 1. Market oriented land market policy in combination with current tax policy. Market oriented land policy would allow survival of the fittest to take place.

Land prices might decline more sharply in the short run until debt levels are reduced to manageable levels for most producers and the supply of land for sale declines to "normal" levels. Agricultural lenders would absorb the decline in asset values on foreclosed land. Farm and nonfarm land buyers face lower land purchase prices.

If combined with current tax policy, however, the decline in land values is slowed by less restrictions on nonfarm investment compared to tax policy that limits nonfarm investment. Additional nonfarm investment agriculture might occur as sale-lease-back-options develop under private initiative and as lenders attempt to move foreclosed land on to the market and off their books.

Option 2. Market oriented land policy and tax policy that limits nonfarm investment. This option would have similar results to Option 1, except that the limits on nonfarm investment in agriculture might tend to create a deeper decline in land values in the short run.

Option 3. Government acquires foreclosed land of private lenders in an attempt to stabilize the land market. Government absorbs part of the lender risk resulting from declining asset values. The government acquired land could be taken out of production or leased back to foreclosed farmers to give them an opportunity to start over under the current rules of the economy. Foreclosed farmers could also be given first option to buy their land back at some specified time in the future.

A government land support and/or lease back program would tend to offset the land market impacts of a change in tax policy that limits nonfarm investment in agriculture. In addition, land would be held for future purchase by farm rather than nonfarm investors.

Option 4. A government program to buy down farm debt might accomplish many of the aspects of Option 3. The major difference is that less foreclosures occur and titles do not transfer from farmers to the government. This option would also tend to offset possible impacts of a change in tax policy that limits nonfarm investment in agriculture because the short-run demand for nonfarm investment would be reduced.

In the final analysis, tax policy is one factor that affects the structure of agriculture. Many of the tax preferences used by nonfarm investors might be eliminated if we changed our tax policy to flatter rates, and eliminated accelerated depreciation, capital gains and investment credit tax preferences. And if we really want to preserve moderate size, pastoral family farm agriculture, additional policy changes could give economic preferences to these farms once we have defined them.

Also, I have not mentioned a word about costs to the Treasury for the various options. For some of the options, significant costs are involved. With a \$215 billion farm debt, for example, a 20% farm debt buy-down program for the 1/3 most financially stressed producers (that hold 2/3 of the farm debt) would cost about \$30 billion. A large

government land purchase program could cost more. Congress would quickly face a "Guns versus Butter" choice once again.

Finally, in a recent 17-state survey of farm policy attitudes of farmers, the message on the budget deficit came through loud and clear. According to 72 to 87% of the producers in all of the states, balancing the budget is a worthy objective. Furthermore, 55 to 72% of producer respondents in all the states agree to across the board expenditure cuts, even if it means cuts in farm program expenditures. However, a plurality of 27 to 48% in the states generally disagree with proposals to freeze expenditures and raise taxes. This implies that expenditure cuts--and only raising taxes as a last resort--is the generally preferred approach.

In closing, I certainly want to commend you Senator for your attempt to gain greater visibility for the the impact of tax policy on agriculture. I wish you best success in taking the message to Washington.